Airline reregulation

Background Paper BP-230E

AIRLINE REREGULATION: THE DISCUSSION IN THE UNITED STATES

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April 1990

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Cat. No. YM32-2/230E

ISBN 0-660-13652-X

CE DOCUMENT EST AUSSI PUBLIÉ EN FRANÇAIS

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INTRODUCTION

Airline deregulation in Canada is in many ways the child of deregulation in the United States. Moves to change the system in the latter country, therefore, may ultimately change the airline system here - and should be watched closely.

After a decade with airline deregulation in the United States, observers see mixed results. Even those who were the staunchest supporters of deregulation in the 1970s now admit that many of its effects were surprising - and not pleasantly so.

One such observer is Alfred E. Kahn. As chairman of the now-defunct Civil Aeronautics Board (CAB), he championed deregulation which, as he had intended, led to the demise of that Board. His work and that of others led to the U.S. Airline Deregulation Act of 1978. By 1988, Kahn was back at Cornell University and, although still a supporter of airline deregulation, after a decade of experience with it, was more cautious when singing its praises.

In a 1988 article(1) Professor Kahn discussed the unexpected results of deregulation under four headings:

1. the turbulence and painfulness of the process;
2. the reconcentration of the industry;
3. the intensification of price discrimination and monopolistic exploitation; and
4. the deterioration in quality of airline service. (p. 316)

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(1) Alfred E. Kahn, "Surprises of Airline Deregulation," American Economic Review, May 1988.

Professor Kahn concluded his article by asserting, however, that deregulation had led to lower fares (with the structure of fares now in line with the structure of costs), greater choice among "price-quality options" and improvements in efficiency - "all this along with a 35% or so decline in accident rates" (p. 321).

Of course, what an advocate of deregulation sees only as a "surprise," others may see as a reason for deep concern and an argument for reregulation. This is, in fact, what is happening in the U.S. today. Since the late 1980s, especially since the tenth anniversary of airline deregulation, there has been a reevaluation of its results.

BACKGROUND

By the time the Airline Deregulation Act came into effect, the United States had had four decades of airline regulation. The Civil Aeronautics Act of 1938 had created the Civil Aeronautics Board (CAB) and given it authority to:

1. control entry;
2. control exit;
3. regulate fares;
4. award direct subsidies;
5. control mergers and intercarrier agreements;
6. investigate deceptive trade practices and unfair methods of competition; and
7. exempt carriers from certain provisions of the Act.(2)

Until the Federal Aviation Act of 1958, the CAB also had authority over safety regulation. Note that power 5 effectively immunized

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(2) This list is from Elizabeth E. Bailey et al., Deregulating the Airlines, the MIT Press, Cambridge, Mass., 1985. This is an excellent study of the early years of airline deregulation in the U.S. by economists who worked at the CAB.

the airline carriers from antitrust laws. In short, the Act of 1938 showed little faith in the market and much faith in government regulation.

Unfortunately for those with faith in regulation, the powers of the CAB and the use of those powers could not keep pace with the rapid changes in the industry. Whether the same powers applied differently could have done so is a moot point. By the mid-1970s, the system had been shaped by over 30 years of regulation; interested parties saw problems and, in the spirit of the times, wanted to rely on greater competition (i.e., deregulation) to solve them.

The situation was summed up for many by the phenomenon of large planes flying half empty. In more technical terms, excess capacity, barriers to entry and high prices were all the obvious signs of a lack of competition.

Another difficulty was that small communities had become dissatisfied with the subsidy program. As part of the 1938 Act, this program was administered by the Postal Service until 1953, and thereafter by the CAB. It involved augmenting passenger revenue by the payment of mail rates. The basic philosophy was that the program would foster the the air carriers' financial prosperity, which, in turn, would provide the underpinning for a nationwide system of air service. The trade-off between an air carrier's financial position and service to small communities was, however, often settled in the air carrier's favour.

A 1976 study by the Department of Transportation found "that certificated air carriers [local service airlines that had taken over subsidized operations from the trunk airlines] dropped service to 173 points between 1960 and 1975, reducing the number of points served by certificated carriers by about 30%. In almost every instance, the initiative for these withdrawals came from the carriers, with the Board granting approval."(3)

Another problem under regulation was that the quality of service (including safety) was "too high." The inverted commas are needed because we seldom think that quality of service, especially with respect to safety, can be too high. It can be if it is a barrier to entry that

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(3) Ibid., p. 23.

prevents airlines from offering consumers service of lower quality but at a correspondingly lower price. It is another moot question, however, whether consumers ever have enough information to make a wise choice between (say) price and safety. This was recognized after deregulation, although an apparent problem then became the low quality of service.

A related "problem" under regulation, where some of the monopoly return to the air carriers went to employees, was that the wages of airline employees were "too high." When the industry became more competitive with deregulation, existing carriers felt pressure to lower their wages so they could compete with new entrants. The resulting downward movement in wages and layoffs led to considerable labour unrest, but also to measured productivity gains.

The problems of "too high" service and "too high" wages were given little weight by proponents of deregulation. The other problems were generally recognized, however, and this recognition led to the Airline Deregulation Act of 1978.

At first, deregulation seemed a glorious success. In the first few years after the Airline Deregulation Act of 1978 removed restrictions on entry into and exit from the airline industry, 215 new airlines were formed. Prices fell and the established carriers were forced to meet the terms offered by such entrants as People Express. More people flew than ever before.

But then the industry changed. There was a doubling of oil prices between 1979 and 1980 and severe recession in the early 1980s, while the huge increase in the number of flyers led directly to several problems. Airport congestion, longer waiting times and cancelled flights became common. Although accidents per passenger-mile decreased during the decade of deregulation, there was growing concern about safety, especially the use of older aircraft and less experienced crew.

Stiff competition had forced the established air carriers to lay off workers or ask them for wage concessions. Both actions lowered staff morale and led to noticeable labour unrest, which added to passengers' concerns about safety.

Without binding restrictions on entry and exit, the look of air travel changed. In place of multi-stop flights on a single aircraft, a system of spoke-and-hub flying evolved; a passenger flying from one small community to another might fly on a small plane to a hub in a larger community, then fly on a larger plane from one hub to another, and then on a smaller plane from the second hub to the destination. This system involved frequent plane changes and additional waits.

While the quality of flying was falling, the major carriers were finding niches where they could exercise monopoly power. Because of space constraints at the hubs (and long-term leases of airport facilities to the major carriers), concentration there increased. And with the increased concentration, fares moved up. Of the 215 new airlines, only 59 had survived by the end of 1989; eight mega-carriers controlled 90% of the U.S. air travel market. At nine major hubs, a single carrier controlled over 60% of all traffic.

To many, the glorious success of deregulation was short-lived and is now being reversed.

RECENT U.S. CONGRESSIONAL ACTIVITY

The concerns described above have naturally led legislators to examine the results of deregulation in detail and to propose laws aimed at correcting some of the apparent harm.

At the end of 1988, the U.S. magazine Business Week looked at a decade of airline deregulation and wrote, "Welcome to Airline Deregulation, Phase Two." At the end of 1989, that same magazine ran a short piece, "Memo to the Airlines: Deregulation's Days are Numbered." Other magazines and scholarly journals have joined the debate. Some take the position that the benefits of deregulation still outweigh the costs, but all note the increased pressure on legislators for reregulation.

The following list gives examples of recent congressional activity. It includes reports, hearings and sessions devoted to appropriations.(4)

H643-19 EXTENSION OF CIVIL PENALTY ASSESSMENT DEMONSTRATION PROGRAM (17 November 1989). This report dealt with the imposition of civil penalties of up to $50,000 for violations of airline security, maintenance and operations regulations.

S263-33 TRANSPORTATION EMPLOYEE TESTING ACT OF 1989 (25 October 1989). This report dealt with the possible establishment of drug and alcohol testing programs for commercial aviation and other transportation employees.

H643-17 REVIEW OF CERTAIN ACQUISITIONS OF VOTING SECURITIES OF AIR CARRIERS (24 October 1989). This report dealt with the prohibition of the acquisition of 15% or more of any major air carrier's voting securities before the Department of Transportation (DOT) has determined the effect of the acquisition on aviation safety, competition and airline assets.

S263-32 ACQUISITION OF CONTROLLING INTEREST IN AIR CARRIER (18 October 1989). This report dealt with the prohibition of the acquisition of 25% or more of an air carrier's voting securities before DOT has determined the effect of the acquisition on aviation safety, competition and airline assets.

S261-66 AIRLINE ACQUISITIONS (14 July 1989). This hearing examined legislation to prohibit the acquisition of a controlling interest in an airline through a leveraged buyout (LBO) unless the

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(4) The information is from Congression Information Service, "Index to Publications of the United States Congress," Abstracts Volume, various issues. The prefix H stands for House of Representatives activity; S stands for Senate activity.

DOT determines that the transaction will not adversely affect aviation safety.

H641-38 FLIGHT ATTENDANT DUTY TIME LIMITATIONS (17 May 1989). This hearing examined the relationship between flight attendant working hours and airline safety.

H181-33.6 APPROPRIATIONS, 1990 - DOT, OFFICE OF THE SECRETARY (21 April 1989). As part of its consideration of the DOT's 1990 fiscal year budget, the Subcommittee on Transportation Appropriations examined: (a) airline passenger mishandled luggage reports; (b) airline passenger consumer complaints; (c) competition in the Airline Computerized Reservation System Industry; and (d) essential air service subsidies.

H641-39 EASTERN AIRLINES LABOUR DISPUTES EMERGENCY BOARD (7 March 1989). This hearing concerned the dispute between Eastern Airlines and its employees.

H641-26 OVERSIGHT OF THE DEPARTMENT OF TRANSPORTATION'S COMMERCIAL AIR CARRIER FITNESS POLICY, FOCUSING UPON THE PROPOSED PRIVATIZATION OF TRANS WORLD AIRLINES (TWA) (29 September 1988). This hearing examined the possible negative impact of securities privatization on TWA service and safety, and the need for DOT to conduct a fitness review of TWA.

H641-19 FAA OVERSIGHT OF THE COMMUTER AIRLINE INDUSTRY (28 September 1988). This hearing reviewed commuter airline safety and related Federal Aviation Administration (FAA) inspection issues.

S261-26 AIRLINE CONCENTRATION AT HUB AIRPORTS (22 September 1988). This hearing examined the impact of airline company mergers on industry competition, focusing on increasing concentrations at hub airports.

S521-14 AIRLINE COMPUTER RESERVATION SYSTEMS (10 December 1987). This hearing examined the impact on airline industry competition and consumers of airline-owned computer reservation systems.

S521-13 PROBLEMS IN THE AIRLINE INDUSTRY (19 August 1987). This hearing before the Subcommittee on Antitrust, Monopolies and Business Rights examined airline service quality problems.

A few comments are necessary about this congressional activity. First, there is possible overlap, as the House and Senate may examine the same issue. For example, both chambers examined the acquisition of controlling interest in an air carrier; however, they looked at different levels of controlling interest.

A second important comment is that the activity listed above does not mean that laws have been passed. The list has been presented to flag concerns of U.S. legislators. Some items will indeed result in new laws or amendments to existing laws. Some, however, may not - or not in the immediate future.

There could also be future legislation in the U.S. that does not - or does not seem to - reflect the activity listed above. This is because of what some have called the "Christmas tree" aspect of some U.S. legislation, to which seemingly unrelated sections are sometimes added, like tree ornaments.

Not all legislation aimed at air travel, moreover, has to do with the results of deregulation. Terrorism directed at airlines has led to laws dealing with airport and airline security. General concerns about drug and alcohol abuse have led to legislative proposals aimed at curbing such abuse, especially in those industries where an employee's actions can affect the safety of many. Deregulation worsened labour relations and this may have led to substance abuse by some employees, but the links are indirect.

These comments should not lessen the impact of the list. The decade under airline deregulation in the U.S. has created many apparent problems. Legislators there - as they would here or in any democracy -

have attempted to address these. The list shows that perceived problems fall into two broad categories: decreasing quality of service (including perceptions of safety) and decreasing competition.

The result has been a closer examination of the U.S. airline industry and, as seen in the list above (and in the following section), legislative activity. A recent article(5) quoted Senator John C. Danforth, a sponsor of one of the bills to be discussed below, as summing up the feeling of many legislators: "We cannot have a system that is both deregulated and uncompetitive." The same article quoted a vice-president of Airline Economics who commented on the U.S. market: "The sad truth is, we don't have enough capacity to have a totally free market."

Deregulation, especially the last five years of it, has certainly resulted in a reinterpretation of the U.S. airline industry and the possible role of regulation.

RECENT U.S. SENATE BILLS

The apparent problems with a deregulated airline industry led to the introduction of two bills in the U.S. Senate at the end of 1989. The two bills were:

S.1741. Airline Competition Enhancement Act
Introduced by Mr. McCain (for himself and Mr. Danforth and Mr. Bond) on 6 October 1989; and

S.1854. Airline Reregulation Act
Introduced by Mr. Metzenbaum (for himself and Mr. Byrd) on 8 November 1989.

These bills show concerns with the same problems but promote different solutions. S.1741 was sponsored by Republicans and attempts to promote further competition by striking at some practices and conditions that have led to increased dominance of the U.S. market by the large carriers. S.1854 was sponsored by Democrats and proposed to establish the "Aviation Policy Board for the purpose of setting air fares and routes, and

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(5) "Should Airlines be Reregulated?" Fortune, 19 June 1989.

requiring the Secretary of Transportation to take certain actions to improve service and promote safety in airline travel."(6)

Bill S.1854 is the more straightforward of the two. It would turn back the clock and rename the Civil Aeronautics Board the Aviation Policy Board. As the bill's co-sponsor, Senator Byrd, said, it gives the opportunity to recast a vote on deregulation (he had voted for the Airline Deregulation Act of 1978).

The application of route and rate regulations - whatever one calls the regulator - is not straightforward. The bill affirms a faith in government regulation without giving much detail about how such regulation in the 1990s would avoid the problems of the 1970s.

As Senator Metzenbaum put it:

> I say with all candor that I am not certain that reregulation is the right solution. But I am sure that deregulation was the wrong solution. I believe it is important to put the idea of reregulation on the table so it can be discussed as one alternative for dealing with the current scandalous state of airline competition.

Bill S.1741, on the other hand, does not want to turn back the clock. Its sponsors have aimed the bill at problems with the current system - especially the market power of the major carriers and inadequate airport capacity.

To combat market power, the bill would:

1. require the mega-carriers to divest themselves of their computer reservation systems (CRS);

2. eliminate code sharing (under which a large airline shares its CRS two-letter designation with a commuter airline - leading travellers to think their flight will take place on a single airline);

3. extend the Federal Trade Commission Act prohibitions against unfair competition and unfair practices to the airline industry; and

4. strengthen the Federal Aviation Act to make it easier for smaller airlines to challenge the larger airlines

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(6) Congressional Record, 8 November 1989, p. S15272.

about unfair methods of competition or deceptive practices.

To increase airport capacity, the bill would:

1. "eliminate the buy-sell rule and recapture the windfall that was given the dominant airlines in 1985 by taking the slots [takeoff and landing rights at four important airports] back and auctioning them off";(7) and

2. permit charges on passengers using airports so that airport capacity could be expanded.

Although the two bills are based on different philosophies with respect to the market and government regulations, they share a view of the failures under a decade of deregulation of the U.S. airlines.

THE SPECIAL POSITION OF SMALL COMMUNITIES

All states in the U.S. have small communities, so it is not surprising that the Airline Deregulation Act of 1978 included a program to ensure that such communities did not lose all their air service in the wake of deregulation. As some observers noted: "This program was something of an anomaly since it increased in some ways the regulation of small community air service in order to allow a massive reduction of regulation for the rest of the system."(8)

The following passage from the Bailey book discusses the guidelines for small community replacement services set out in section 419 of the Airline Deregulation Act of 1978 (ADA):

> The Board issued a set of guidelines in September 1979 that attempted to balance the needs and desires of the communities and the Act's general philosophy of relying on competitive forces to determine service level and quality at these communities. Regional hearings were held before the guidelines were issued in order to obtain comments from state, community and other interested parties. The guidelines guaranteed support for levels of traffic of up to a maximum of 80 seats

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(7) Congressional Record, 6 October 1989, p. S12923.

(8) Bailey et al. (1985), p. 111.

> daily in each direction. Larger volumes were deemed able to support themselves. The Board guaranteed access to a city (or sometimes to two cities) that had close commercial, political and geographical ties to the community and that provided it with access to the national air transportation system. Flights were required to be well-timed and to allow for the possibility of same-day round-trip service. In general, aircraft had to have two engines and to be operated by two pilots.
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> The replacement process was designed to proceed fairly smoothly. A certificated carrier had to notify the Board 90 days before suspending service at a community. The Board covered the incumbent's losses for subsequent periods of 30 days until a replacement carrier was found. At those communities where no carrier was willing to provide subsidy-free air service, the CAB invited service proposals including subsidy requests from interested carriers. On the basis of the service proposals, the carrier's service record, and the community's preferences, the Board selected a carrier to serve the community generally for a two-year period. The ADA also ordered substantial changes in the local service subsidy program effective on 1 January 1983, at which time any carrier could replace or bump an existing 419 carrier by showing that it could improve service and reduce subsidy.(9)

Section 406 of the ADA stipulated that the subsidy to local service carriers would continue until 1985. In 1977, this subsidy peaked at $79.8 million; by 1982, it was down to $45.6 million, while the subsidy under section 419 had reached $18.7 million. In other words, four years after deregulation, the subsidies for service to small communities (the total of 406 and 419 subsidies) was $64.3 million, a drop of almost 20% from 1977.

The ADA also required that joint fares be extended to commuter carriers. This provision expired in 1983 and the major air carriers have since cancelled joint fares with regional carriers other than those with which they had a code-sharing agreement. (In many cases the majors had a financial interest in these regionals.)

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(9) Ibid., p. 116-117.

There is debate about the effects of deregulation on small communities. Some argue that service has improved, with more departures from these communities. Others point out that the more numerous flights are on smaller, less comfortable aircraft and, given the spoke-and-hub system that has emerged, the flights involve transfers at larger airports and inevitable delays. Even supporters of deregulation admit that the costs and benefits of deregulation have been unevenly distributed.

Some small communities have certainly been losers under deregulation. It is not surprising, therefore, that Senators McCain, Danforth and Bond, who sponsored Bill S.1741, come from Arizona and Missouri, states of predominantly small communities.

CONCLUSIONS

It is too early to say whether the U.S. Congress will pass an airline reregulation law. The two relevant bills before the Senate show that attempts at reregulation can take different forms - a return to the pre-1978 system of regulation or an attempt to aim new regulations at problems arising after the 1978 Act.

The sponsors' discussion of the bills and the record of other congressional activity show clearly that problems seem to have emerged after a decade of airline deregulation. Although there were over 200 new entrants into the U.S. market immediately after deregulation and fares dropped and the number of travellers increased, the market is now becoming more concentrated and congestion and deteriorating service are facts of life.

Of the new entrants, only about 59 remain. The major carriers have found ways to exercise monopoly power - through, for example, the aggressive use of computer reservation systems or mergers and increased concentration at hubs. As Senator Danforth put it: "Consumers are not getting the benefits that vigorous competition was supposed to provide." A co-sponsor of Bill S.1741 summed up trends in the United States: "...[W]e are entering, if we have not entered, a state of de facto reregulation."

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